In the Supreme Court of the United States.

OCTOBER TERM, 1923.

CHARLES V. DUFFY, COLLECTOR OF INTERNAL REVENUE for the United States for the Fifth District of New Jersey, Petitioner,
v.
THE CENTRAL RAILROAD COMPANY OF NEW JERSEY, Respondent.
} No.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT.

The Solicitor General, on behalf of Charles V. Duffy, Collector of Internal Revenue for the Fifth District of New Jersey, prays that a writ of certiorari issued to review the judgment of the Circuit Court of Appeals for the Third Circuit, rendered in the above case on May 3, 1923, affirming the judgment of the District Court for the District of New Jersey.

STATEMENT OF THE CASE.

This is an action instituted by the Central Railroad Company of New Jersey, against Charles V. Duffy, Collector of Internal Revenue for the United States for the Fifth District of New Jersey, to recover back

income taxes in the sum of $72,010.22, with interest thereon from June 15, 1917, alleged to have been erroneously collected by petitioner from respondent for the year 1916. The case was tried before the District Court for the District of New Jersey, which gave judgment for the respondent in the sum of $70,980.03, and an appeal being taken to the Circuit Court of Appeals for the Third Circuit, the judgment of the District Court was affirmed. Petitioner now seeks to have this judgment of the Circuit Court of Appeals, affirming the judgment of the District Court, reviewed by writ of certiorari.

QUESTIONS INVOLVED.

I.

Whether expenditures made by a railroad company, on properties held by it under leases, for the construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands, locating and paving new streets, are "ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties" within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

II.

Whether expenditures made by a railroad company, on properties held by it under leases, for the construction of new buildings, new additions and betterments to old structures, new bridges, road-

beds, new tunnels, acquiring new lands, locating and paving new streets, are "rentals or other payments required to be made as a condition to the continued use or possession of the property to which the railroad company has not taken or is not taking title," within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

III.

Is Article 140 of Treasury Department Regulations 33 (Revised) inconsistent with Section 12 (a) of the Revenue Act of 1916?

STATUTE INVOLVED.

Section 12 of the Revenue Act of 1916 reads in part as follows:

> SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
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> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity * * *."

THE FACTS.

The Central Railroad of New Jersey during the year 1916 was the lessee of several branch railroads

under long-term leases. Under these leases the railroad company was required to maintain and keep the leased premises and all their appurtenances in good repair and condition, and in all respects fit for use as a railroad. The leases provided that the expenses for maintaining the leased premises should be borne by the respondent, and that at the termination of the leases all improvements erected thereon by the respondent should revert to and become the property of the lessors. The leases also contained the usual covenant that upon default in making payments of rental or in keeping the covenants, the lessor could terminate the lease by giving notice.

The respondent was also lessee from the city of New York of certain piers in the city of New York, under the terms of which the respondent agreed to construct new piers and extend old piers. The terms of these leases were for a less number of years than the railroad leases. They provided that the lessor, for the failure on the part of respondent to keep the covenants of the leases, could terminate the leases, and in such event all the improvements erected by the respondent would revert to and become the property of the lessor.

The Central Railroad Company of New Jersey during the year 1916 expended a total sum of $1,659,924.33 for (1) additions and betterments to its leased railroads and branches, (2) construction of and extension to leased piers, and (3) dredging the piers (the amount spent for dredging being only $66.62).

The expenditures made by the respondent on its leased railroads were for the construction of new buildings, new additions and betterments to old structures, improving roadbeds, buildings, new bridges, roadbeds, new tunnels, replacing old devices with new and better ones, acquiring new lands, and paving new streets. The unexpired terms of the leases were longer than the life of any of the improvements, and consequently the respondent will get the full beneficial use of them. None of these leases required the respondent to construct any of the above-named improvements.

The expenditures made by respondent under the leases held by the city of New York were for the construction of new piers and the extension of old piers. Therefore, all of the improvements for which respondent expended the sum of $1,659,924.33 were permanent, and constituted capital investments. These leases did not require the respondent to expend any sum whatsoever during the year 1916.

Respondent maintains and contends that it is entitled to deduct the full amount of $1,659,924.33 from its gross income for the year 1916 on the ground that this expenditure represented ordinary and necessary expenses paid within the year as a condition to the continued use of the leased premises.

The petitioner, however, contends that the said expenditure was a capital expenditure, and that the same could not be deducted all in one year, but should be prorated over the life of the improvements, or the life of the lease, whichever is shorter, as pro-

vided by Article 140 of Regulations 33 (revised), which is as follows:

> ART. 140. *Permanent improvements under lease.*—The cost of erecting permanent buildings, or of making permanent improvements on ground leased by a company, is held to be an additional rental and is therefore a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease, revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease and the annual deduction will be an aliquot part of such cost. (As to income to lessor, see paragraph 50, page 11, these regulations.)

In rendering judgment the Circuit Court of Appeals held that the above regulation, in so far as it required a prorating of the expenditures, was inconsistent with the plain provisions of the statute.

REASONS FOR GRANTING THE PETITION.

1. The Circuit Court of Appeals erred in holding that the respondent was entitled to deduct the full sum of $1,659,924.33 from its gross income for the year 1916, expended for the construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands and paving streets.

2. The Circuit Court of Appeals erred in holding that Article 140 of Regulations No. 33 (revised) in so far as it requires a prorating of the capital expenditures, was inconsistent with the provisions of Section 12(a) of the Revenue Act of 1916.

3. The construction of subdivision First of Section 12(a) of the Revenue Act of 1916 has never been before this court, nor before any lower court except in the instant case and the case of *Kemper Military School* v. *Crutchley*, 274 Fed. 125. In the latter case court reached an opposite conclusion to that reached by the Circuit Court of Appeals in the instant case, and, therefore, there is a conflict between Federal courts of different circuits.

4. The question involved in the present case is one of general interest and public importance to all taxpayers. (*Fields* v. *United States*, 205 U. S. 292). It not only involves hundreds of thousands of dollars in revenue to the Government but it also involves the equitable right of a taxpayer to a return of his money spent for capital improvements placed upon land held under lease. Under the decision of the Circuit Court of Appeals taxpayers having annual capital expenditures in excess of their annual incomes are denied their equitable right to a full return of their capital, e. g., a taxpayer, as lessee of land which produces no income, expends during a current year $2,000,000 for the construction of a new building. He realizes no income from the building until the following year, and, therefore, if compelled to take the deduction in the year the expenditures were made, he would never get a return of his capital expenditures.

JAMES M. BECK,
Solicitor General.
MABEL WALKER WILLEBRANDT,
Assistant Attorney General.

BRIEF IN SUPPORT OF PETITION.

The fundamental question in this case is whether the expenditures made by the respondent for the purposes herein set forth were capital expenditures. If they were capital expenditures, then they can not under any interpretation of the law be deducted in full in determining the net taxable income for the year 1916. They must be spread over the life of the improvements or over the life of the lease, whichever is shorter. In order to sustain the judgment of the Circuit Court of Appeals it will be necessary to hold that the expenditures were "ordinary and necessary expenses paid within the year in the maintenance and operation" of its business and properties "as a condition to the continued use and possession" of its leased properties.

POINT I.

The construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands, locating and paving new streets, were not "ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties," and therefore are not proper deductions within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

The expenditures made by the respondent on its leased properties were not "ordinary and necessary expenses paid within the year in the maintenance and

operation of its business and properties," but were capital expenditures. They were not such improvements as ordinarily recur in the operation of respondent's business. What constitutes capital expenditures and what constitutes ordinary and necessary expenses has been determined by this court in the case of *Illinois Central Railroad Co.* v. *Interstate Commerce Commission*, 206 U. S. 441, in which, at page 462, the following language was used:

> The findings show that the old rates were profitable and that the dividends were declared even when permanent improvements and equipment were charged to operating expenses. But may they be so charged? Appellants contend that the answer should be so obviously in the affirmative that it should be made an axiom in transportation. On principle it would seem as if the answer should be otherwise. It would seem as if *expenditures for additions, to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the* period of their duration, and that *improvements that will last many years should not be charged wholly against the revenue of a single year.*

And at page 463:

> We think, it is clear, that instrumentalities which are to be used for years should *not be paid for by the revenues of a day or year;* and this is the principle of returns upon capital which exists in durable shape. [Italics ours.]

The second subdivision of Section 38 of the Corporation Excise Act of 1909 (36 Stat. 112) provides among other things:

> Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; * * *

It is thus seen that this section is almost identical with Section 12(a) of the Revenue Act of 1916.

Under this section the Grand Rapids & I. Ry. Company claimed the right to deduct from its gross income money expended for additions and betterments to its properties, but this was denied by the Commissioner of Internal Revenue, whereupon it instituted suit against Emanuel J. Doyle, Collector of Internal Revenue for the District of Michigan (*Grand Rapids & I. Ry. Co.* v. *Doyle*, 245 Fed. 792) to recover the amount of the taxes paid. In the course of its opinion the court said:

> * * * Are these expenditures included in the "necessary expenses of the maintenance and operation of the plaintiff's railway property and business?" In my judgment, they are not. In each instance it is an addition to

the property, and an addition to the value of the property of the railway company. It is an improvement of its property; it is an extension of its property; it is an addition not only to its inventory value but to its real and actual value.

It is a well-known fact that corporations in general, both railway and manufacturing companies, often use a part of their net earnings and income in the extension and improvement of their plans and property and business. Nearly every corporation of an industrial character does that, and in many cases industrial corporations do not declare dividends for a number of years after their organization, for the very reason that they are extending and improving an addition to their property. But amounts so expended in additions are no less income than they would be if paid to the stockholders as dividends, and no less income or additions to the value than if the amount had been carried into a surplus account and placed in bank.

The case of *Kemper Military School* v. *Crutchley*- 274 Fed. 125, arose in the Western District of Mis, souri, and as heretofore stated, involved the interpretation of Section 12 (a) of the Revenue Act of 1916, and in that case the taxpayer was denied the right to deduct expenditures for capital improvements from gross income of a single year.

POINT II.

The expenditures made by respondent were not payments of rentals or other payments required under the terms of the lease as a "condition to the continued use or possession of its properties" for the year 1916 within the meaning of the Revenue Act of 1916, Section 12(a).

None of the leases required the respondent to erect new buildings, bridges, tunnels, or any new improvements, except the leases requiring the construction of the new piers and the extension of the old piers, and none of the leases required the respondent to expend the said sum of $1,659,924.33, or any part thereof, during the year 1916. Therefore, these expenditures were not recurring expenditures, and were not ordinary and necessary within the meaning of Section 12(a) of the Revenue Act of 1916 and were not a condition to the continued use of respondent's properties.

POINT III.

Article 140 of Regulations 33 (Revised) is consistent with Section 12(a) of the Revenue Act of 1916.

At the time the above regulation was promulgated to carry into effect the provisions of Section 12(a) of the Revenue Act of 1916, it was recognized by those entrusted with the enforcement of the law that taxpayers who erected new buildings on properties held under lease could not always obtain a return in full of their capital expenditures if they were compelled to take the deduction from the gross income for the year in which the capital expendi-

tures were made. During the year in which a taxpayer expends large amounts for capital improvements, his income is insufficient to permit a full deduction of the expenditures. With this in mind, the officials of the Treasury Department provided in the regulations referred to that the cost of permanent improvements placed upon leased property should be prorated over the life of the lease or over the life of the improvements, whichever is shorter, allowing every taxpayer who erects permanent improvements on his leased property a return in full of his capital expenditures. As heretofore stated, the decision of the Circuit Court of Appeals denies the taxpayer this right, as it compels the taxpayer to take the deduction for capital expenditures during the year in which expenditures were made.

The executive construction of Section 12(a), as shown by the regulations, was known to Congress when it enacted Section 234(a) of the Revenue Act of 1918, which is almost identical with Section 12(a) of the Revenue Act of 1916, and in effect constitutes a reenactment of that section. This reenactment, therefore, is an approval or ratification on the part of Congress of such construction. (*United States* v. *Falk*, 204 U. S. 143; *United States* v. *Hermanos y Campania*, 209 U. S. 337; *Komada* v. *United States*, 215 U. S. 392; and *National Lead Co.* v. *United States*, 252 U. S. 140.)

CONCLUSION.

In conclusion, it is respectfully submitted that the writ of certiorari should be issued as prayed.

JAMES M. BECK,
Solicitor General.

MABEL WALKER WILLEBRANDT,
Assistant Attorney General.

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